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C O N F I D E N T I A L SECTION 01 OF 03 ABU DHABI 004555

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TAGS: EFIN EINV ECON GCC AE
SUBJECT: UAE- MONETARY UNION AND REVALUATION

REF: A. ABU DHABI 3709
¶B. ABU DHABI 2913
¶C. ABU DHABI 1472

Classified By: AMBASSADOR MICHELE SISON FOR REASONS 1.4 (B) AND (D).

¶1. (C) Summary: UAE Central Bank Governor Al-Suwaidi said that the GCC would need "to talk about" the implications of Oman's decision not to join the GCC currency union as currently scheduled. So far, the UAE Central Bank appears to be resisting any changes to the dirham's peg to the dollar or revaluation of the currency. Central Bank officials note that imported inflation is not a major problem. They note that UAE inflation is largely driven by structural bottlenecks (such as housing) which are slowly unwinding. A revaluation, in their view, would not necessarily slow the growth in liquidity in the UAE and might increase it. In addition, revaluation would come with costs (to the value of overseas investments, the competitiveness of non-oil exporters, to tourism receipts, etc.), which would need to be considered. Poor trade statistics would limit the effectiveness of changing the peg to a basket of currencies. The Central Bank's Economic Advisor did note that other UAE entities have been putting pressure on the Central Bank either to revalue or change the peg, and that he has started to do a more detailed cost benefit analysis on his own initiative. He stressed, however, that so far the Central Bank Governor believes that the costs of change outweigh the benefits. End Summary.

¶2. (C) The large foreign exchange reserves accumulated by GCC countries over the last few years, the weakness of the dollar, and increased inflation in the UAE have heightened speculation that GCC countries might either change from a dollar peg or revalue their currencies. UAE's Central Bank Governor Sultan Nasser Al-Suwaidi has consistently resisted either revaluing or changing the peg in advance of the GCC's planned monetary union in 2010. Oman's announced decision that it would not join the monetary union as currently scheduled appears to be forcing an evaluation of the currency union and may move the question of changes to the peg forward. So far, however, the UAE Central Bank does not appear to believe that either revaluation or changing the peg is in the UAE's interest.

Prospects for Currency Union - TBD

¶3. (SBU) On the margins of the December 20-21 meeting of the UAE's national Anti-Money Laundering Committee, Al-Suwaidi told Econchief that the GCC "would need to discuss" the issue of the currency union. He has previously been quoted as

saying that he thought the currency union would move forward but in a more limited fashion.

¶4. (C) On December 19 Central Bank Economic Advisor Abdalla Malki told Econchief that most of the technical issues related to a currency union had already been agreed to. The decision to proceed was essentially a political one, which had not played itself out. Malki also said that, although the criteria for a currency union were generally achievable (budget deficit, gross debt, inflation), the influx of liquidity from high oil prices made it more difficult to achieve the inflation target. Malki went on to say that the GCC states needed to have a common basis for measuring economic statistics. He noted that while the UAE was currently running an inflation rate of about 10%, he seriously doubted that the Saudi figure of 2% inflation was accurate. "Are they measuring the same thing?" he asked rhetorically.

Al-Suwaidi still resistant to changes to peg

¶5. (C) Al-Suwaidi has consistently resisted changing the UAE's peg to the dollar, either by pegging to a basket of currencies or by revaluing. He has said that he thinks that a future GCC common currency would eventually float, but has intimated that the time is not right for the UAE to move to a flexible exchange rate. Malki explained that the Governor believed that the costs of revaluing would exceed the benefits. In addition, he noted, any change would need to be coordinated at the GCC level. Kuwait had pegged to the dollar with a small adjustment band, he explained, a unilateral revaluation was within its rights under the GCC agreement. Even so, he noted, Kuwait's action had caused

tension within the GCC. The UAE had a hard peg to the dollar and did not have the same room to maneuver. Malki confided that -- on his own initiative -- he was starting to examine more closely the costs and benefits of revaluation, but explained that, so far, the Governor was not convinced of the merits of change.

Dollar Weakness not major cause of inflation

¶6. (C) Malki told Econchief that "other entities" in the UAE had put some pressure on the Central Bank to either revalue or to break the peg. He commented that they were operating under the -- mistaken -- assumption that a peg to the weakening dollar was a major cause of imported inflation. According to the Central Bank's estimates, 70% of the UAE's exports are denominated in dollars (90% if re-exports are excluded). Around 80% of the UAE's imports are either dollar denominated or in currencies pegged to the dollar. According to Malki, even the Japanese price their exports to the UAE in dollars. The 20% not in dollars was represented largely by Euro-zone exports. Malki stated that the UAE's inflation was more related to structural inflexibilities in "non-tradables" such as rents and other local costs that were being driven by excessive growth. Malki noted that the UAE Minister of Labor had said that he had issued 500,000 labor permits in 2005. Even if only half of the permits actually led to new people coming to the UAE, this represented a 6% increase in the population of the UAE in one year. Many of these people would need housing, food, and other services. (Note: some large percentage of these immigrants would be relatively unskilled construction laborers, who would be housed in labor camps and not put pressure on the housing market. End note). Malki noted that inflationary pressures were expected to decline in 2007 as more housing units came on the market and the rate of rent increases dropped. (Note: Both Dubai and Abu Dhabi have also instituted rent caps, which should slow the increase in rents. End note.) Malki noted that he thought that inflation in the UAE was already coming down. Food prices were dropping back toward those of the beginning

of the year. If inflation drops, he said, he anticipated that the "political" pressure to revalue would decline.

Lots of Liquidity - Revaluation won't stop it

¶7. (C) Malki argued that a credible peg had proven beneficial by limiting currency risks and reducing hedging costs. The UAE Central Bank had proven that the peg was credible, by providing the market with all the dollars demanded. The UAE was already attracting a great deal of foreign investment ($20 billion in 2006, two-thirds more than in 2005). A more valuable currency could be more attractive to investors leading to even greater inflows of capital (and greater inflationary pressure). Malki acknowledged that the Central Bank mirrored low U.S. interest rates, which encouraged growth. He commented, however, that increasing interest rates would only make investments in the UAE more attractive and could attract more capital inflows. Malki explained that the UAE already had high reserve requirements of 14% on many types of deposits in an effort to control the growth in the money supply. Increasing these rates would only cause banks to shift deposits to their foreign branches then borrow the money from abroad to finance lending in the UAE and avoiding the reserve requirements. He noted that foreign liabilities of the commercial banks had already increased by an estimated 70% in 2005 indicating that some banks were already following this strategy.

Trade weighted peg founders on poor statistics
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¶8. (C) Malki stated that the UAE's statistics were problematic. Although the central bank had good statistics on the financial system, statistics on the real economy were poor. Malki noted that not only were the baskets of goods used in calculating the Consumer Price Index (CPI) dated, they were based on a city of Abu Dhabi survey that was not relevant to other parts of the UAE. These statistical issues made pegging to a trade weighted basket of currencies difficult, he explained. He said that he had once recommended pegging the dirham to a basket of currencies, but had discovered that the trade statistics were unreliable, with IMF data differing significantly from the data provided by the Emirates' customs departments.

Comment

¶9. (C) The weakness of the dollar, higher inflation, and diminishing prospects for a currency union all appear to be putting pressure on GCC nations to revalue. In the UAE's case, however, the Central Bank Governor still appears to believe that the costs of near-term change outweigh the benefits. The Central Bank has significant dollar holdings. Well over 90% of its estimated $28 billion in reserves are in dollars. ADIA has an even larger value of dollar assets. Revaluing the dirham would undermine the value of these holdings. Revaluing the currency could also hurt the UAE's efforts to diversify its economy away from oil and gas by making other exporters less competitive and making the UAE a more expensive destination for European tourists. (Note: Since many of the UAE's developing new industries from aluminum to cement to petrochemicals are growing to meet rapid domestic growth, impact on export competitiveness might not be that important a consideration. End Note.)

¶10. (C) The Central Bank is also not likely to accept the argument that a revaluation in the dirham will help reduce global savings imbalances or trade imbalances with the U.S. specifically. According to the latest IMF estimates, the increase in imports from 2005 to 2006 roughly paralleled the increase in exports (28% for exports and 24% for imports). U.S. exports to the UAE have already grown rapidly and the

U.S. has traditionally maintained a trade surplus with the UAE. U.S. exports to the UAE for the first 10 months of 2006 are already 18% greater than those for all 2005.

11 (C) Although we judge that Governor Al-Suwaidi has calculated that changing the peg or revaluing the dirham has more costs than benefits, he is subject to both external and internal pressures. If the GCC commits to a revaluation, the UAE will likely follow consensus. At the moment, however, it does not appear that the UAE will lead a charge toward change. The UAE's response could change if the dollar collapses or if the Central Bank's cost benefit calculations shift. It is instructive that Malki is starting to look more closely at the details of a revaluation, should the question be asked.

End Comment.
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